

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-5785-99

GAKindel

date: **OCT 28 1999**

to: Examination Division, Southern California District, San Diego
ATTN: Terry Sparks, Team Coordinator

from: Associate District Counsel, Southern California District, San Diego

subject: Payment of Royalties to [REDACTED] by U.S. Subsidiaries
Fiscal Years ending [REDACTED] through [REDACTED]

This memorandum responds to your request for advice on whether certain U.S. subsidiaries of [REDACTED], a [REDACTED] corporation, are "contract manufacturers" and whether certain technical assistance fees and royalties paid by the U.S. subsidiaries to [REDACTED] are deductible pursuant to I.R.C. § 162.

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether [REDACTED], [REDACTED], and [REDACTED] are "contract manufacturers."
2. Whether [REDACTED], [REDACTED], and [REDACTED] are entitled to deduct technical assistance fees and royalties paid to [REDACTED] during the fiscal years ending [REDACTED], through [REDACTED].

CONCLUSIONS

1. At this stage, we cannot reach a conclusion on whether [REDACTED], [REDACTED], and [REDACTED] are contract manufacturers. [REDACTED], [REDACTED], and [REDACTED] have characteristics that are typical of contract manufacturers and characteristics that are atypical of contract manufacturers. Therefore, we recommend that you ask the economist engaged by the Service how he treated [REDACTED], [REDACTED], and [REDACTED] for transfer pricing purposes and treat them consistently. We also recommend that you engage an engineer to perform a functional analysis of [REDACTED], [REDACTED], and [REDACTED] and determine whether they indeed are contract manufacturers.
2. The Service has not provided sufficient basis for disallowing the deductions claimed by [REDACTED], [REDACTED], and [REDACTED] in full. According to the Service, [REDACTED], [REDACTED], and [REDACTED] are contract manufacturers and, as such, they would not customarily pay royalty fees. Even assuming that [REDACTED], [REDACTED], and [REDACTED] are contract manufacturers, the Service has not presented any evidence supporting its conclusion. In fact, the Service has provided licensing agreements between [REDACTED] and unrelated parties that support an opposite conclusion, i.e., contract manufacturers do pay royalty fees. We recommend, therefore, that you determine whether the amounts paid by [REDACTED], [REDACTED], and [REDACTED] are reasonable, considering transactions entered into by parties dealing at arm's length and the value of the patent or other intangible being licensed.

FACTS

I. PLAYERS

[REDACTED] is a [REDACTED] corporation engaged in the manufacture and sale of [REDACTED] and [REDACTED]. [REDACTED] owns approximately [REDACTED] companies in [REDACTED] countries, [REDACTED] of which are found in the United States.

[REDACTED] is a Delaware corporation wholly owned by [REDACTED]. [REDACTED] manufactures [REDACTED]

██████████ for sale to distributors, including ██████████ and ██████████, a wholly owned subsidiary of ██████████

██████████ is a Delaware corporation wholly owned by ██████████. ██████████ manufactures ██████████ for sale to ██████████ distributors, including ██████████ and ██████████.

██████████ is a Delaware corporation wholly owned by ██████████. ██████████ manufactures ██████████, and ██████████.

██████████ is a Delaware corporation wholly owned by ██████████. ██████████ distributes products manufactured by related entities within the United States.

II. ACTIVITIES OF ██████████, ██████████, AND ██████████

A. GENERAL ANALYSIS

The economist engaged by the Service described ██████████, ██████████, and ██████████ as "independent manufacturers that perform manufacturing and assembly services for companies that market ██████████ and/or ██████████." See ██████████

██████████, p. III-1 (██████████) (the "Economist's Report").¹ The economist determined the functions performed and risks assumed by ██████████, ██████████, and ██████████ to be as follows:

<u>Function</u>	██████████	██████████	██████████
Materials/Component Purchasing	Y	Y	Y
Manufacture of Components	Y	Y	
Final Product Manufacturing/Assembly	Y		Y
Testing & Quality Control	Y	Y	Y
Inventory & Warehousing*	Y	Y	Y
Product Shipping	Y	Y	Y
Product Distribution		Y	
Credit and Collection*	Y	Y	Y
Product Warranty*	Y	Y	Y
Repair, Service & Tech. Assistance	Y		Y

See id.

¹ It is our understanding that the economist's report for the years ██████████ through ██████████ is substantially similar to the Economist's Report for the years ██████████ through ██████████.

In his analysis, the economist defined "independent manufacturer" as follows:

. . . independent manufacturers perform no product related sales or marketing functions. Advertising and other sales costs should be limited to those required to recruit and maintain a customer/client base for manufacturing services. The typical independent manufacturer does not perform research and development (R & D) or other product development or design functions and should incur no costs related thereto except as a contract service with reimbursement and compensation. However, if such contract services were extensive, they would constitute an additional service segment. Therefore, if data disaggregated by function were not available, then an independent manufacturer could not be used as a comparable for tested parties that did not perform a similar mix of "for fee" services.

See id. at p. III-1. In addition, he found that independent manufacturers do not own the patents, trademarks or brand names associated with the products, and do not share in the profits or risks associated with these intangibles. See id.

The economist found [REDACTED], [REDACTED], and [REDACTED] to be independent manufacturers for the following reasons:

Of the functions listed in [the table above], only those marked with an asterisk are considered to entail particular risks at the level in which the [REDACTED] manufacturing entities participated. Varying degrees of insulation from the full level of risks assumed by vertically integrated enterprises in the [REDACTED] markets were afforded these manufacturing entities. In that regard, they were very similar to independent manufacturers that produce exclusively or primarily under contract to the marketers of their products. Independent manufacturers own no significant intangibles; patents, trademarks and brand names are owned by the manufacturer's client/customer. While some independent manufacturers may own patents or other proprietary interests in manufacturing

equipment or processes, such intangibles are considered to place those firms in a special category that would not be included in a set of comparables for the [REDACTED] entities.

While no formal written contracts between the [REDACTED] manufacturing entities and [REDACTED] or [REDACTED]-related affiliates were provided to the audit team, the responsibilities and liabilities of those entities as described by [REDACTED] representatives were nearly identical to those contained in contracts between unrelated parties for the manufacturing of products. In such arm's length contracts, risk with respect to the procurement of materials and components are limited by the ability to commit to purchases based on contract orders for the products to be manufactured. In this regard, the [REDACTED] entities fit within one or both of the two types of relationship [sic] generally applicable to contract manufacturers: (1) "consignment" manufacturing, wherein the client provides materials and components so that the manufacturer is performing a pure manufacturing service function; and (2) "turn-key" manufacturing, wherein the manufacturer procures all materials required in the manufacture or assembly of the products being produced under contract. Whereas the [REDACTED] entities purchased and took title to product components and raw materials, their sources were often limited primarily to related parties.

See id. at pp. III-1 - III-2.

It is our understanding, after reading the above discussion as well as discussing the operations of [REDACTED], [REDACTED], and [REDACTED] with the prior revenue agent, that [REDACTED], [REDACTED], and [REDACTED] manufactured products in accordance with purchase orders received from their customers. That is, they did not produce any units prior to receiving the orders or any units in excess of the amount ordered. We do not have, however, any documents supporting this understanding.

B. [REDACTED]

[REDACTED] manufactured [REDACTED] for both related and unrelated marketers of [REDACTED] products in [REDACTED]

██████████, ██████████ and ██████████. See Economist's Report, pp. VI-1 and VI-2.

The ██████████ operation was formed during ██████████ through a subcontracting arrangement with a related ██████████, ██████████, which performed all labor functions associated with the assembly of ██████████. See Economist's Report, p. VI-1. ██████████ was owned by ██████████, a wholly owned subsidiary of ██████████, and the manufacturing assets are owned by ██████████. ██████████ reimbursed ██████████ for the labor costs plus ██████████ percent. ██████████ also paid ██████████ a lease fee for the use of the ██████████ industrial facility and paid ██████████ a royalty for technical assistance in running the manufacturing operation. See id.

██████████ "was provided with designs and manufactured to specifications and had no significant patents or intangibles, . . . it sold the bulk of its output to unrelated customers and was responsible for finding and retaining them." See id. at p. VI-2 (quoting ██████████). ██████████ was "just like an independent manufacturer." Id. (quoting ██████████). ██████████).

C. ██████████

██████████ manufactured ██████████ for ██████████ and ██████████ and also imported ██████████ and finished parts from ██████████ for resale to original equipment manufacturers. See Economist's Report, p. IX-1. ██████████ manufactured the ██████████ in ██████████. ██████████ contracted with ██████████ for the performance of all labor function associated with the assembly of ██████████ in ██████████. ██████████ owned all of the manufacturing assets used by ██████████. See id.

D. ██████████

██████████ manufactured ██████████, ██████████, and ██████████ for ██████████ in ██████████ and ██████████. See Economist's Report, p. VII-1. ██████████ contracted with ██████████ for the performance of all labor functions associated with the assembly of ██████████ and ██████████ in ██████████. ██████████ owned all of the manufacturing assets used by ██████████. See id.

III. TECHNICAL ASSISTANCE AND ROYALTY AGREEMENTS

A. TECHNICAL ASSISTANCE AGREEMENTS

██████████ and ██████████ entered into a Technical Assistance Agreement on ██████████. Pursuant to the Technical Assistance Agreement, ██████████ granted ██████████ a non-exclusive right and license (1) to use the "technical information" of ██████████ with respect to the manufacture of ██████████ and (2) to make use of the patents applicable to the ██████████ owned by ██████████. See Technical Assistance Agreement, Art. 2. The term "technical information" means drawings and specifications of the ██████████, list of component parts, process specifications, performance specifications of the ██████████, test data, lay-out of manufacturing facilities, list of machinery and equipment and other technical information necessary for the manufacture of the ██████████ which are owned by ██████████. See Technical Assistance Agreement, Art. 1(B).

After the effective date of the Technical Assistance Agreement (i.e., ██████████), ██████████ was required to provide ██████████ with all of the "technical information" necessary to manufacture the ██████████. See Technical Assistance Agreement, Art. 3(A). And ██████████ was required to manufacture the ██████████ "strictly in accordance with the TECHNICAL INFORMATION furnished by [██████████]." See Technical Assistance Agreement, Art. 3(C). After an approved request by ██████████, ██████████ was required to send its skilled engineers to ██████████'s plant to provide instruction and guidance with respect to the use of the technical information. See Technical Assistance Agreement, Art. 4(A). The expenses associated with dispatching the skilled engineers to ██████████'s plant were borne and paid by ██████████. See Technical Assistance Agreement, Art. 4(C).

In addition, the parties recognized that, for technical and quality reasons, ██████████ would purchase from ██████████ certain machinery equipment, materials, and component parts. See Technical Assistance Agreement, Art. 8(A). ██████████ retained the right to establish the quality and performance standards for machinery equipment, materials, and component parts procured by ██████████ from any sources other than ██████████. See *id.*

As compensation for the technical information, ██████████ agreed to pay ██████████ a royalty equal to \$██████████ for each ██████████ manufactured and sold by ██████████. See Technical Assistance Agreement, Art. 6. The parties, however, amended the Technical Assistance Agreement on three occasions to adjust the amount of the royalty for the period from ██████████, to ██████████, the

royalty due and payable by [REDACTED] was exempted. See Memorandum dated [REDACTED]. For the period from [REDACTED] to [REDACTED], the royalty was reduced from \$ [REDACTED] per unit sold to \$ [REDACTED] per unit sold. See Memorandum dated [REDACTED]. Effective as of [REDACTED], the reduction from \$ [REDACTED] per unit sold to \$ [REDACTED] per unit sold was permanent. See Amendment dated [REDACTED].

The term of the Technical Assistance Agreement originally was 2 years from the effective date. See Technical Assistance Agreement, Art. 12. However, the term is automatically extended each year for one year periods, unless either party gives written notice of termination. See id.

All of the [REDACTED] manufactured and sold by [REDACTED] were required to bear the trademarks of "[REDACTED]" or "[REDACTED]" both of which are owned by [REDACTED]. See Technical Assistance Agreement, Art. 9. [REDACTED] and [REDACTED] entered into a separate trademark license agreement. Id.

[REDACTED] and [REDACTED] entered into a Technical Assistance Agreement on [REDACTED]. Pursuant to the Technical Assistance Agreement, [REDACTED] granted [REDACTED] a non-exclusive right and license (1) to use the "technical information" of [REDACTED] with respect to the manufacture and/or assembly of [REDACTED] and (2) to make use of the patents applicable to the [REDACTED] owned by [REDACTED]. See Technical Assistance Agreement, Art. 2.00. The term "technical information" means drawings and specifications of the [REDACTED], list of component parts, process specifications, performance specifications of the [REDACTED], test data, lay-out of manufacturing facilities, list of machinery and equipment and other technical information necessary for the manufacture of the [REDACTED] which are owned by [REDACTED]. See Technical Assistance Agreement, Art. 1.02.

After the effective date of the Technical Assistance Agreement (i.e., [REDACTED]), [REDACTED] was required to provide [REDACTED] with all of the "technical information" necessary to manufacture the [REDACTED]. See Technical Assistance Agreement, Art. 3.01. And [REDACTED] was required to manufacture the [REDACTED] "strictly in accordance with the TECHNICAL INFORMATION furnished by [REDACTED]." See Technical Assistance Agreement, Art. 3.03. After an approved request by [REDACTED], [REDACTED] was required to send its skilled engineers to [REDACTED]'s plant to provide instruction and guidance with respect to the use of the technical information. See Technical Assistance Agreement, Art. 4.01. The expenses associated with dispatching the

skilled engineers to [REDACTED]'s plant were borne and paid by [REDACTED]. See Technical Assistance Agreement, Art. 4.03 and 4.04.

In addition, [REDACTED] was required to purchase all machinery, equipment, materials, and component parts necessary for the manufacture and/or assembly of [REDACTED] from [REDACTED]. See Technical Assistance Agreement, Art. 8.01. Before [REDACTED] could purchase any machinery, equipment, materials, and component parts from any sources other than [REDACTED], [REDACTED] was required to obtain prior written approval of [REDACTED] as to the quality and performance of such parts. See id.

As consideration for the technical information, [REDACTED] agreed to pay [REDACTED] a royalty equal to [REDACTED] percent of the selling price of all [REDACTED] manufactured and sold by [REDACTED] minus landed cost of materials and component parts supplied by [REDACTED]. See Technical Assistance Agreement, Art. 6.00.

The term of the Technical Assistance Agreement originally was [REDACTED] years from the effective date. See Technical Assistance Agreement, Art. 12. However, the term is automatically extended each year for one year periods, unless either party gives written notice of termination. See id.

[REDACTED] and [REDACTED] entered into a Technical Assistance Agreement on [REDACTED]. Pursuant to the Technical Assistance Agreement, [REDACTED] granted [REDACTED] a non-exclusive right and license (1) to use the "technical information" of [REDACTED] with respect to the manufacture of [REDACTED] and [REDACTED] and (2) to make use of the patents applicable to the [REDACTED] and [REDACTED] owned by [REDACTED]. See Technical Assistance Agreement, Art. 2. The term "technical information" means drawings and specifications of the [REDACTED] and [REDACTED], list of component parts, process specifications, performance specifications of the [REDACTED] and [REDACTED], test data, lay-out of manufacturing facilities, list of machinery and equipment and other technical information necessary for the manufacture of the [REDACTED] and [REDACTED] which are owned by [REDACTED]. See Technical Assistance Agreement, Art. 1(B).

After the effective date of the Technical Assistance Agreement (i.e., [REDACTED]), [REDACTED] was required to provide [REDACTED] with all of the "technical information" necessary to manufacture the [REDACTED] and [REDACTED]. See Technical Assistance Agreement, Art. 3(A). And [REDACTED] was required to manufacture the [REDACTED] and [REDACTED] "strictly in accordance with the TECHNICAL INFORMATION furnished by [REDACTED]." See Technical

Assistance Agreement, Art. 3(C). After an approved request by [REDACTED] was required to send its skilled engineers to [REDACTED]'s plant to provide instruction and guidance with respect to the use of the technical information. See Technical Assistance Agreement, Art. 4(A). The expenses associated with dispatching the skilled engineers to [REDACTED]'s plant were borne and paid by [REDACTED]. See Technical Assistance Agreement, Art. 4(C).

In addition, [REDACTED] was required to obtain prior written approval of [REDACTED] as to the quality and performance of any machinery, equipment, and materials procured by [REDACTED] from any source other than [REDACTED]. See Technical Assistance Agreement, Article 7(A).

The term and method of compensation is determined from time to time "upon mutual consideration between the parties." See Technical Assistance Agreement, Art. 6(B). Initially, [REDACTED] agreed to exempt [REDACTED] from the royalty to help [REDACTED] establish its competitiveness in the market. See letter dated [REDACTED] from [REDACTED] of [REDACTED] to [REDACTED] of the Service. On [REDACTED], [REDACTED] agreed to pay [REDACTED] percent of the "added value" of all [REDACTED] and [REDACTED] manufactured and sold by [REDACTED] for the period from [REDACTED] to [REDACTED]. See Memorandum No. 2 dated [REDACTED], ¶ 2. The term "added value" is defined as the sales price of the [REDACTED] and [REDACTED] minus the costs of material delivered to [REDACTED] from [REDACTED]. See Memorandum No. 2, ¶ 3. Beginning [REDACTED], the royalty for technical assistance was [REDACTED] percent of added value. See Memorandum dated [REDACTED], ¶ 2. Apparently, [REDACTED] intends to increase the royalty on occasion until the royalty reaches [REDACTED] percent of added value. See letter dated [REDACTED].

The term of the Technical Assistance Agreement originally was [REDACTED] years from the effective date. See Technical Assistance Agreement, Art. 11. However, the term is automatically extended each year for one year periods, unless either party gives written notice of termination. See id.

All of the [REDACTED] and [REDACTED] manufactured and sold by [REDACTED] were required to bear the trademark of "[REDACTED]". See Technical Assistance Agreement, Art. 8.

B. ROYALTY AGREEMENTS

[REDACTED], [REDACTED], and [REDACTED] entered into other royalty agreements, in addition to the technical assistance agreements. These royalty agreements fall within one of three categories:

1. Contracts between [REDACTED] and [REDACTED], or [REDACTED] pursuant to which [REDACTED], [REDACTED], or [REDACTED] "reimburse" [REDACTED] for lump sum payments made by [REDACTED] to an unrelated party to purchase a license to use that party's patents.
2. Contracts between [REDACTED] and [REDACTED], or [REDACTED] pursuant to which [REDACTED], [REDACTED], or [REDACTED] pays [REDACTED] a royalty comparable to the royalty that [REDACTED] must pay an unrelated party for a license to use that party's patents.
3. Contracts between [REDACTED] and an unrelated party that grant [REDACTED] a license to use that party's patents.

Below is a sample of the royalty agreements.

Category 1 - Allocation of Lump Sum Royalty Fees

On [REDACTED], [REDACTED], acting on behalf of itself and in the interest of its subsidiaries, entered into a license agreement with [REDACTED], the owner of approximately [REDACTED] active patents and [REDACTED] pending patent applications. [REDACTED] granted to [REDACTED] and its subsidiaries² a nonexclusive license to "practice . . . any and all inventions claimed in" [REDACTED]'s patents (with some exceptions) from [REDACTED] through the full term of the patents. As compensation for the license, [REDACTED] and its subsidiaries agreed to pay [REDACTED] a lump sum of \$[REDACTED]. It is our understanding that [REDACTED] paid [REDACTED] \$[REDACTED] as required by the agreement.

Shortly thereafter, [REDACTED] entered into agreements with [REDACTED] and [REDACTED] in which [REDACTED], [REDACTED], and [REDACTED] agreed to "reimburse" [REDACTED] for their shares of the lump sum payment made to [REDACTED] over an [REDACTED]-year period. Each subsidiary's share equaled approximately \$[REDACTED] multiplied by a percentage equal to that subsidiary's "US annual sales including export sales" over the "total U.S. sales of [REDACTED] and its subsidiaries including import to and export to the U.S.A." See Agreement for Payment of Royalties on [REDACTED] Patents dated [REDACTED], between [REDACTED] and [REDACTED], Art. 3.

Category 2 - Payment of Non-Lump Sum Royalty Fees

On [REDACTED], [REDACTED] entered into a Licence Agreement for [REDACTED] for [REDACTED] with [REDACTED].

² [REDACTED] and its subsidiaries are singularly and jointly referred to as "Licensee" throughout the license agreement. See Agreement dated [REDACTED], between [REDACTED] and [REDACTED].

█████ granted █████ and its subsidiaries³ a non-exclusive license "to manufacture, have manufactured, sell, use, lease or otherwise transfer Licensed Products only, which Licensed Products are designed and intended for use" in the █████ by a █████ or in the █████ . As compensation, █████ and its subsidiaries agreed to pay █████ royalties pursuant to the following schedule:

1. \$█████ for each unit sold, leased, or otherwise transferred from █████ up to and including █████;
2. \$█████ for each unit sold, leased, or otherwise transferred from █████ up to and including █████;
3. \$█████ for each unit sold, leased, or otherwise transferred from █████ up to and including █████;
4. \$█████ for each unit sold, leased, or otherwise transferred from █████ up to and including █████;
5. \$█████ for each unit sold, leased, or otherwise transferred in excess of █████.

See License Agreement dated █████, between █████ and █████, ¶ 5.1

Shortly thereafter, █████ entered into an agreement with █████ in which █████ agreed to reimburse █████ "the amount equivalent to the patent fees payable by [█████] under the Licensed Agreement." See Agreement dated █████, between █████ and █████, ¶ 1.

Category 3 - Contracts between █████ and Unrelated Parties

On █████, █████ entered into a license agreement with █████ in which █████ granted █████ a non-exclusive license under all █████ patents to make █████ and to use, sell, lease, or otherwise dispose of such █████ . As compensation, █████ agreed to pay █████ \$█████ for each █████ manufactured and sold by █████.

IV. ADJUSTMENT FOR YEARS █████ THROUGH █████

The Service previously audited █████, █████ and █████ for fiscal year ending █████ through fiscal year ending █████ . During the audit, the Service developed two issues,

³ █████ and its subsidiaries are jointly referred to as "Licensee" throughout the license agreement. See License Agreement dated █████, between █████ and █████

among others, (1) whether, pursuant to I.R.C. § 482, the Service could allocate income from [REDACTED] to [REDACTED], [REDACTED], and [REDACTED] in order to clearly reflect the income of these corporations, and (2) whether [REDACTED], [REDACTED], and [REDACTED] were entitled to deduct as ordinary and necessary business expenses technical assistance fees and royalties paid by them to [REDACTED].

A. SECTION 482 ADJUSTMENT

The economist engaged by the Service used the Comparable Profits Method ("CPM") in determining whether and to what extent it should adjust the income of [REDACTED], [REDACTED], and [REDACTED] pursuant to I.R.C. § 482. The economist concluded that [REDACTED], [REDACTED], and [REDACTED] shared the following functional characteristics:

1. manufactured/assembled products/components designed by the client/customer
2. manufactured/assembled [REDACTED] and/or [REDACTED] products and/or components
3. provided products for sale under the brand name of others, including [REDACTED]
4. delivered products to [REDACTED] its affiliates and/or mass retail customers
5. produced products only when they were ordered by [REDACTED] or a mass marketing client
6. was involved in relatively mature industries and product lines
7. purchased or received materials and components primarily from [REDACTED] and its affiliates
8. owned no significant intangibles (patents, trademarks, brand names, proprietary processes)
9. did not assume primary design, development, product liability or marketing risks
10. assumed liability which was limited to manufacturing quality and reliability
11. had no significant R & D functions or expenditures
12. depended on [REDACTED] for engineering and technical assistance functions
13. had no significant advertising or marketing functions/expenses

See Economist's Report, p. V-1. Therefore, the economist used the following criteria in selecting the comparables used with the CPM:

1. had functions which were limited to manufacturing/assembly of [REDACTED], [REDACTED], and [REDACTED] products and/or components
--additional functions limited to less than [REDACTED] percent of revenues

- procurement of materials and components limited to those required to manufacture customers' products
- sales function limited to marketing of manufacturing services
- 2. did not assume primary design, development, product liability or marketing risks
- 3. had no significant intangibles (i.e., customer owns any patents, brand names)
- 4. had no significant advertising or promotional functions/expenses
- 5. had no related party suppliers or customers
- 6. had no foreign plants or significant foreign sales operations
- 7. was similar to [REDACTED], [REDACTED], and [REDACTED] in terms of maturity of company and product lines
- 8. had no bankruptcies or significant legal problems
- 9. had sales between \$[REDACTED] and \$[REDACTED] for fiscal year [REDACTED] through [REDACTED].

See id. at p. V-3. In essence, the economist sought "contract manufacturers" as comparables, a term defined by the economist to mean companies "whose profits depend primarily on the production of products for sale by others, rather than one that is also involved in design, services and/or marketing." See id. at p. V-4.

The economist ultimately used eight comparables in its analysis. The following is a partial table of "Manufacturing Comparables" set forth in the Economist's Report:

<u>Company Name</u>	<u>Functions (per 10K)</u>
[REDACTED]	Manufactures to Customer Specifications
[REDACTED]	Contract Manufacturing
[REDACTED]	Manufactures to Customer Specifications
[REDACTED]	Contract Manufacturing, Field & Engineering Services
[REDACTED]	Contract Manufacturing
[REDACTED]	Contract Manufacturing
[REDACTED]	Contract Manufacturing & Services
[REDACTED]	Contract Manufacturing

See id. at p. V-8.

B. SECTION 162 ADJUSTMENT

It is our understanding that, in determining whether to disallow the deductions for royalty and technical assistance payments, the Service relied on the functional analysis performed by the economist and found [REDACTED], [REDACTED], and [REDACTED] to be contract manufacturers. The Service then determined that the royalties paid by [REDACTED], [REDACTED], and [REDACTED] were not ordinary and necessary business expenses of a contract manufacturer. In addition, the Service argued:

It [is] also apparent that neither [REDACTED] nor the domestic entities have taken the steps necessary to qualify the technical assistance and [REDACTED] Allocation costs for a deduction. The corporations did not provide during the examination any information to show that the rates charged are at "arms-length" or meet other applicable standards. In the case of the [REDACTED] Allocation costs, the parties failed to consider whether the domestic companies utilized the licensed patents or the number of patents which had been utilized. In addition, the cost allocation methods do not bear any relationship to the benefit received by the domestic companies if any. It is merely a method of spreading costs among [REDACTED]'s' [sic] operating divisions.

See Form 886-A, Explanation of Items, for [REDACTED] and [REDACTED] for years ending [REDACTED], [REDACTED] through [REDACTED], [REDACTED], p. 9 (emphasis in original).

V. EXAMINATION OF YEARS [REDACTED] THROUGH [REDACTED]

You are currently examining whether [REDACTED], [REDACTED], and [REDACTED] are entitled to deduct as ordinary and necessary business expenses technical assistance fees and royalties paid by them to [REDACTED] during the fiscal years ending [REDACTED], [REDACTED] through [REDACTED], [REDACTED]. Specifically, you are considering whether [REDACTED], [REDACTED], and [REDACTED] are contract manufacturers and whether, as contract manufacturers, [REDACTED], [REDACTED], and [REDACTED] may deduct royalties paid to a customer.

DISCUSSION

I. WHAT IS A CONTRACT MANUFACTURER?

A. DEFINITION

The term "contract manufacturer" has not been explicitly defined in the context of I.R.C. § 482 or I.R.C. § 162. The term "contract manufacturing," however, has been defined in the context of I.R.C. § 936 (relating to Puerto Rico and possession tax credit).

Pursuant to the regulations promulgated under I.R.C. § 936, the term "contract manufacturing" includes "any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person if the unrelated person:

(1) Performs work on inventory owned by a member of the affiliated group for a fee without the passage of title;

(2) Performs production activities (including manufacturing, assembling, finishing, or packaging) under the direct supervision and control of a member of the affiliated group; or

(3) Does not undertake any significant risk in manufacturing its product (e.g., it is paid by the hour)."

Treas. Reg. § 1.936-5(c) Ans. 1. An arrangement will be treated as contract manufacturing even if the unrelated party uses an intangible owned or licensed by the possessions corporation (or another member of the affiliated group) as long as the unrelated party makes use of the patent in producing the product which becomes part of the product of the possessions corporation. Treas. Reg. § 1.936-5(c) Ans. 2.

In addressing whether a corporation is a contract manufacturer for purposes of I.R.C. § 482, the courts take a similar approach as the regulations under I.R.C. § 936. Specifically, the courts have focused on two elements necessary for finding a corporation to be a contract manufacturer: (1) lack of risk and (2) lack of control.

The first element involves the question of whether the corporation bears any risk with respect to the volume of its product that it is able to sell and the price at which it is able to sell it. See Bausch & Lomb Inc. and Consol. Subsidiaries v. Commissioner, 92 T.C. 525, 583-84 (1989), aff'd 933 F.2d 1084 (2nd

Cir. 1991); see also Sundstrand Corp. and Subsidiaries v. Commissioner, 96 T.C. 226, 357 (1991). In Bausch & Lomb, the Service argued that Bausch & Lomb Ireland Ltd. ("B&L Ireland"), a lower-tier subsidiary of Bausch & Lomb, Inc. ("B&L"), "was little more than a contract manufacturer the sale of whose total production was assured and who thus was not entitled to the return normally associated with an enterprise which bears the risk as to the volume of its product it will be able to sell and at what price." Bausch & Lomb at 583. The Tax Court agreed that B&L Ireland would have been a contract manufacturer in substance if it had found that B&L was required to purchase B&L Ireland's production of soft contact lenses. But the Tax Court found that B&L had not guaranteed that it would import substantial quantities of lenses produced by B&L Ireland and had not guaranteed that the price paid to B&L Ireland would remain constant. Id. at 584. While the Court found that B&L Ireland had certain expectations as to the volume and price of lenses it could anticipate selling to B&L, the Court concluded that these expectations were no different than those which any supplier has with regard to the business of a major customer and did not constitute a guarantee which insulated B&L Ireland from market risks. Id.

The second element involves the question of whether the corporation has control over its operations. See Sundstrand, 96 T.C. at 357-58. In Sundstrand, the Service argued that Sundstrand Pacific (Pte) Ltd. ("SunPac"), a wholly-owned subsidiary of Sundstrand Corporation, was a contract manufacturer or subcontractor of Sundstrand. The Tax Court, however, concluded that SunPac did not act as a contract manufacturer or subcontractor in form or substance.

As [Sundstrand's] licensee, [SunPac] owned the right to use the intangible property transferred to it under the SunPac License Agreement; it had the right to sell SunPac parts throughout the world to unrelated parties; it purchased its own materials (albeit through petitioner) and bore the inventory, production, and market risks with respect to its product; it scheduled its own production runs and was responsible for its own quality control; and it performed a variety of machining operations and processes.

Id. at 357.

B. APPLICATION

████, █████, and █████ have characteristics similar to those of contract manufacturers. First, █████, █████, and █████ did not bear any risk as to the volume of their products that they were able to sell. They received purchase orders from their customers setting forth the number of units needed, and they manufactured that number of units.⁴ Second, █████, █████, and █████ apparently did not exercise much control over their operations. They were required to manufacture their products in strict compliance with the design, specifications, and other technical information provided by █████. They could not purchase machinery, equipment, materials, or component parts from sources other than █████ without █████'s prior approval. And, according to the prior revenue agent, they did not perform any functions without getting instruction from █████.

At the same time, however, █████, █████, and █████ have characteristics different than those of contract manufacturers. First, the purchase orders for the products manufactured by █████, █████, and █████ were not unconditional. The prior revenue agent stated that the customer was not required to accept all of the products manufactured pursuant to the purchase orders; the customer could return a defective unit and avoid paying the cost of that unit. Second, █████, █████, and █████ bore risks not typically borne by contract manufacturers. For example, according to the table on page 3, above, █████ bore the costs associated with (1) warehousing, (2) credit and collection, (3) product warranty, and (4) repair, service, and technical assistance.

We recommend that you take two steps in determining whether to treat █████, █████, and █████ as contract manufacturers. First, you should talk with the economist who applied the Comparable Profits Method to █████, █████, and █████ and determine whether he treated █████, █████, and █████ as contract manufacturers for his analysis. If the economist did not treat █████, █████, and █████ as contract manufacturers for purposes of I.R.C. § 482, you should not treat them as contract manufacturers for purposes of I.R.C. § 162. If you do treat them as such, you are taking a position inconsistent with that of the economist. On the one hand, you would treat █████, █████, and █████ as contract manufacturers and argue that they do not owe a royalty to █████. On the other hand, you would not treat █████, █████, and █████ as contract manufacturers for transfer pricing purposes and argue that

⁴ As noted below, however, the prior revenue agent implied that the purchase orders were not unconditional. Specifically, he indicated that the customer could return defective products for a full or partial refund. As a consequence, █████, █████, and █████ bore some risk that their products would not be accepted.

they must receive a return on their intangibles, i.e., the intangibles that they license from [REDACTED]. Second, you should engage an engineer to evaluate the functions performed by [REDACTED] and [REDACTED] and to determine whether they are indeed contract manufacturers.

In addition, we recommend that you consider the following questions with respect to [REDACTED], [REDACTED], and [REDACTED]:

1. Who contracts with the purchaser? [REDACTED]? Or [REDACTED] [REDACTED], or [REDACTED]?
2. What are the terms of the contract?
3. How is the cost of the products manufactured by [REDACTED] [REDACTED], and [REDACTED] determined?
4. Who pays [REDACTED], [REDACTED] and [REDACTED] for the products manufactured and sold?
5. When are [REDACTED], [REDACTED], and [REDACTED] paid for the products manufactured and sold?
6. Once the purchaser submits a purchase order, is it obligated to pay for each unit ordered? May the purchaser refuse delivery? May the purchaser return unneeded products?
7. Who bears the risk if the unit manufactured is defective? Purchaser? Or [REDACTED], [REDACTED] or [REDACTED]?
8. Do [REDACTED], [REDACTED], and [REDACTED] truly bear the cost of warehousing, credit and collection, warranty, and service and repair?

And you should obtain the following documents:

1. Contracts between the purchaser and [REDACTED] if any;
2. Contracts between the purchaser and [REDACTED] and [REDACTED], if any;
3. Contracts, other than the Technical Assistance Agreements, between [REDACTED] and [REDACTED], [REDACTED] and [REDACTED] relating to the manufacture and sale of their products, if any; and
4. Purchase orders.

This information should assist you in analyzing the issue.

II. DEDUCTIBILITY OF TECHNICAL ASSISTANCE FEES AND ROYALTIES

I.R.C. § 162 allows a taxpayer a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business including royalty fees or other similar fees that are incurred as a condition to the continued use or possession of property to which the taxpayer does not hold title. The "arm's length" test often associated with I.R.C. § 482 is equally applicable in ascertaining

the "ordinary and necessary" character of a payment to a related party. The R.T. French Co. v. Commissioner, 60 T.C. 836 (1973).

While transactions between a corporation and its parent are not condemned automatically as shams, they do invite close scrutiny. The Nestle Co., Inc. v. Commissioner, T.C. Memo. 1963-14 (citing Differential Steel Car Co. v. Commissioner, 16 T.C. 413 (1951)). The validity of the agreements and the reasonableness of the amounts paid must be considered in determining whether the payments were in fact royalties or simply disguised dividends. Id. (citing Granberg Equip., Inc. v. Commissioner, 11 T.C. 704 (1948) and W.N. Thornburgh Mfg. Co. v. Commissioner, 17 B.T.A. 29 (1929)). An agreement between a corporation and its parent is valid and enforceable, if the arrangement is fair and reasonable, judged by the standards of a transaction entered into by parties dealing at arm's length. Id. (citations omitted). Specifically, royalties paid by a corporation to its parent for use of a patent or process owned by the parent are deductible by the corporation as a business expense, provided that the amount paid is reasonable, considering the value of the patent or process and its salability in the open market. Id. (citations omitted).

A. TECHNICAL ASSISTANCE AGREEMENTS

1. Validity of Agreements

The Technical Assistance Agreements between (1) [REDACTED] and [REDACTED] (2) [REDACTED] and [REDACTED], and (3) [REDACTED] and [REDACTED] contain the basic ingredients for licensing agreements. They describe the information and patents being licensed; they impose an obligation on [REDACTED] to provide technical assistance; they set forth the amount of the royalty; and they specify the term of the license. See id.

On the face, therefore, the Technical Assistance Agreements seem valid. You should consider, however, (1) whether the technical information and patents licensed to [REDACTED], [REDACTED], and [REDACTED] had value such that an unrelated party would have paid a royalty to use them and (2) whether the parties acted in accordance with the terms of the agreements. For example, did [REDACTED] provide [REDACTED], [REDACTED], and [REDACTED] with the technical information necessary to manufacture their products? Did [REDACTED] instruct [REDACTED], [REDACTED], and [REDACTED] on the use of this information? Did [REDACTED] provide [REDACTED], [REDACTED], and [REDACTED] with technical assistance when problems arose? Did [REDACTED], [REDACTED], and [REDACTED] pay the royalties provided under the agreements?

The Service argues that the parties did not comply with the provisions of the Technical Assistance Agreements. In support of this position, the Service points to two facts. First, [REDACTED] agreed to pay [REDACTED] \$[REDACTED] per unit manufactured and sold. But [REDACTED] never did

pay [] this amount. In fact, [] did not pay any royalty for the years from [] through [], and paid a reduced royalty after []. Second, [] often used a standard rate for the Technical Assistance Agreements of [] percent of added value. [], however, did not require [] to pay this amount; [] exempted [] from paying any royalty for the first few years of the contract and then imposed a royalty of only [] percent and [] percent in later years.

In response to these arguments, [] cites to seemingly legitimate business purposes. [] allegedly was [] at the time it was exempted from paying the \$[] per unit royalty. Similarly, [] allegedly agreed to a [] percent royalty for [] in order to help [] increase its competitiveness in the industry in the early years.

A reduction in the royalty to meet legitimate business purposes is not necessarily detrimental to the validity of the agreements. See Differential Steel Car Co. v. Commissioner, 16 T.C. 413, 424 (1951), acq. 1951-2 C.B. 2. The reduction in royalty was "designed so as not to kill the goose that laid the golden egg." Id. We note also that the royalties set forth in the Technical Assistance Agreements were computed at either a fixed amount per unit or a percentage of added value and that they were not dependent on the profits of [], [], or []. See id.

2. Reasonableness of Amount Paid

The Service argues that the amounts paid by [], [], and [] pursuant to the Technical Assistance Agreements are not reasonable, because [], [], and [] have not provided any evidence indicating that royalty fees are customarily paid by contract manufacturers. The Service, however, has not provided any information suggesting that royalty fees are not customarily paid by contract manufacturers and has not provided any basis for concluding that the royalty fees paid by [], [], and [] were not reasonable.

We cannot accept the Service's proposition without more information. First, the Service has provided licensing agreements between [] and unrelated parties that clearly do not support the Service's position. Pursuant to the licensing agreements between [] and [], [] is required to pay [] a royalty equal to \$[] per [] manufactured and sold. The Service has not presented any arguments that this licensing agreement, or any other licensing agreement between [] and an unrelated party, was not negotiated at arm's length or that the royalty paid by [] was otherwise unreasonable. If [] is, in fact, a contract manufacturer, the existence of this licensing agreement undermines the Service's proposition that contract manufacturers do not

customarily pay royalty fees. Second, in Bausch & Lomb, the Service argued that B&L Ireland was a contract manufacturer of B&L. But it did not question the payment of a royalty by B&L Ireland to B&L.⁵ Third, the regulations promulgated under I.R.C. § 936 define the term "contract manufacturing" to include an arrangement in which the manufacturing corporation uses an intangible owned or licensed by the corporation seeking the services of the manufacturing corporation as long as the manufacturing corporation uses the intangible in producing its product. Treas. Reg. § 1.936-5(c) Ans. 2.

We recommend, therefore, that you evaluate whether the royalties paid by [REDACTED], [REDACTED], and [REDACTED] under the Technical Assistance Agreements are reasonable by applying an arm's length standard and comparing them to royalties paid between unrelated parties under similar circumstances. In doing so, we also recommend that you examine the value of the technical information and patents licensed to [REDACTED], [REDACTED], and [REDACTED] by [REDACTED] the extent to which [REDACTED], [REDACTED], and [REDACTED] used the technical information and patents, and the amount, if any, that unrelated parties would pay to use the technical information and patents licensed by [REDACTED].

B. ROYALTY AGREEMENTS

1. Category 1 - Allocation of Lump Sum Royalty Fees

As described above, [REDACTED], on its own behalf and on behalf of its subsidiaries, entered into agreements with unrelated parties to use those parties' patents or other intangible in the manufacture of its products and agreed to pay them a lump sum fee for such use. Because [REDACTED] did not itself manufacture products, it passed the burden of paying the lump sum fee to its subsidiaries that did manufacture the products. That is, [REDACTED] demanded reimbursement from [REDACTED], [REDACTED], and [REDACTED] for their respective shares of the lump sum royalty paid by [REDACTED]. [REDACTED] calculated the amount owed by [REDACTED] for example, by first amortizing the lump sum over a period of years and multiplying the amount for one year by the ratio of [REDACTED]'s total U.S. sales for the previous year to the total U.S. sales of [REDACTED] and its affiliates.

⁵ Admittedly, the Service did not have any incentive to attack the royalty paid by B&L Ireland to B&L. The Service was not concerned with the taxable income of B&L Ireland; rather it was concerned with allocating income from B&L Ireland to B&L under I.R.C. § 482. The Service could accomplish this goal by arguing either for an increase in the royalty paid by B&L Ireland or for a decrease in the transfer price paid by B&L to B&L Ireland for contact lenses.

This arrangement is not patently unreasonable. Theoretically, [REDACTED], [REDACTED], and [REDACTED] paid the same amount to [REDACTED] that they would have paid to the unrelated party had they entered into the licensing agreement directly with the unrelated party.

You should, however, consider whether, and to what extent, [REDACTED], [REDACTED], and [REDACTED] actually used the patents and other intangibles licensed by the unrelated parties in the manufacture of their products. Clearly, if [REDACTED], for example, did not use the patents licensed by [REDACTED] to [REDACTED] and its subsidiaries in the manufacture of its [REDACTED], [REDACTED] should not assume any responsibility for reimbursing [REDACTED] for the lump sum paid by [REDACTED] to [REDACTED]. And if [REDACTED] did use the patents licensed by [REDACTED] to manufacture all of its products, the computation of [REDACTED]'s share of the lump sum payment should not include the sales of those products the manufacture of which did not involve the [REDACTED] patents.

2. Category 2 - Payment of Non-Lump Sum Royalty Fees

As described above, [REDACTED], on its own behalf and on behalf of its subsidiaries, entered into agreements with unrelated parties to use that party's patents or other intangible in the manufacture of its products and agreed to pay them a royalty for such use. Because [REDACTED] did not itself manufacture products, it passed the burden of paying the royalty to its subsidiaries that did manufacture the products.

This arrangement is not patently unreasonable. [REDACTED], [REDACTED], and [REDACTED] paid the same amount to [REDACTED] that they would have paid to the unrelated party had they entered into the licensing agreement directly with the unrelated party.

You should, however, consider whether, and to what extent, [REDACTED], [REDACTED], and [REDACTED] actually used the patents and other intangibles licensed by the unrelated parties in the manufacture of their products. Clearly, if [REDACTED], for example, did not use the patents licensed by [REDACTED] to [REDACTED], [REDACTED] should not pay any royalties to [REDACTED]. And if [REDACTED] did not use the patents licensed by [REDACTED] to manufacture all of its products, it should not pay any royalties with respect to those products the manufacture of which did not involve the [REDACTED] patents.

3. Category 3 - Contracts between [REDACTED] and Unrelated Parties

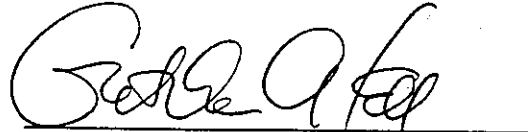
The Service has not provided any basis, other than the general argument that contract manufacturers do not pay royalty fees, for disallowing the deduction of royalty fees paid by [REDACTED] to unrelated parties. As noted above, we do not find the Service's argument compelling. The licensing agreements between [REDACTED] and the unrelated

parties presumably were negotiated at arm's length and presumably contained terms and conditions often found in agreements between unrelated parties. Accordingly, [REDACTED] should be entitled to deduct the royalty fees paid pursuant to these licensing agreements.

If you have any questions, please call the undersigned at (619) 557-6014.

GORDON L. GIDLUND
Assistant District Counsel

By:

A handwritten signature in dark ink, appearing to read "Gretchen A. Kinde", written over a horizontal line.

GRETCHEN A. KINDEL
Attorney